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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 583.

SUFFOLK SECURITIES CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF.

DAVID A. BUCKLEY, JR.,
Attorney for Petitioner.

LORING M. BLACK,
HARVEY L. RABBITT,
Of Counsel.

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INDEX

Subject Index

	Page
Petition for Writ of Certiorari	1
Opinions below	2
Questions presented	2
Statutes involved	2
Statement	2-3
Specification of errors	5
Reasons for granting the writ	5
Brief in Support of Petition	7
Opinions below	7
Jurisdiction	8
Questions presented (see petition)	8
Statutes involved (see petition)	8
Statement (see petition)	8
Specification of errors (see petition)	8
Argument	8
Point I. The evidence did not support the ultimate conclusion and decision of the Board of Tax Appeals	8
Point II. The taxes as assessed are violative of the Fifth and Tenth Amendments to the Constitution	15
Conclusion	16
Appendix:	
Laws of Delaware 1929	17
Revenue Act of 1928, Section 104	17-18
Revenue Act of 1928, Section 115	18

Table of Cases.

American Steel & Wire Co. v. *Eddy*, 138 Mich. 403; 101 N. W. 578	9
Barclay & Co. v. *Edwards*, 267 U. S. 442	15
Brushaber v. *Union Pacific R. Co.*, 240 U. S. 1	15

Page

Cannon v. *Wiscassett Mills Co.*, 195 N. C. 119; 141 S. E. 344 3
Carter v. *Carter Coal Co.*, 298 U. S. 238..... 15
Chevrolet Motor Company v. *United States*, 64 Ct. Cl. 211, Certiorari Denied, 277 U. S. 585..... 12
Chicago Stockyards Company v. *Commissioner*, 129 Fed. (2d) 937 .....12, 14
Child Labor Tax Case, 259 U. S. 34..... 15
W. S. Farish & Co., 38 B. T. A. 150.....9, 10
Farmer v. *Commissioner*, 126 F. (2d) 542..... 12
Flint v. *Tracy Co.*, 220 U. S. 107-171..... 12
Foley Securities Corporation v. *Commissioner*, 106 F. (2d) 731 10
Helvering v. *Canfield*, 281 U. S. 163..... 13
Helvering v. *Jarvis*, 123 F. (2d) 742..... 10
Helvering v. *National Grocery Company*, 304 U. S. 282-286 15
Helvering v. *Tex-Penn Company*, 300 U. S. 481..... 12
Hill v. *Wallace*, 259 U. S. 44..... 15
Lipke v. *Lederer*, 259 U. S. 557..... 15
Ida C. McKinney, 32 B. T. A. 450..... 10
Mobile & Ohio Ry. Co. v. *Tennessee*, 153 U. S. 486-497 9-13
Nicholas v. *Coolidge*, 275 U. S. 531..... 15
Patty v. *Helvering*, 98 F. (2d) 717..... 10
Estate of James H. Post, B.T.A. Docket No. 83921, Memorandum Opinion 14
Randall as Trustee of Bush Terminal Company v. *Bailey, et al.*, 23 N. Y. S. (2d) 173..... 15
Reinstrom v. *Commissioner*, 125 F. (2d) 790..... 10
A. D. Sanger, Inc. v. *Commissioner*, 84 F. (2d) 23-24. 11
Siegman v. *Electric Vehicle Co.*, 140 Fed. 17..... 9
United States Industrial Bankers Securities Corporation v. *Higgins*, 104 F. (2d) 177 12
United States v. *State Street Trust Company*, 124 F. (2d) 948 12
United States v. *Treadway Coal Co.*, 75 F. (2d) 336.. 14
United States v. *Jin Fuey Moy*, 241 U. S. 394..... 15
Vogtman v. *Michaels Mortgage and Credit Company*, Delaware Chancery Reports, Vol. 20, Page 364.. 15
R. M. Weyerhaeuser, 33 B. T. A. 594-597..... 9
Willcuts v. *Milton Dairy Company*, 275 U. S. 215.... 13
Whitaker v. *Amwell National Bank*, 52 N. J. Eq. 400; 29 Atl. 203 9

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner, Suffolk Securities Corporation, a corporation, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Second Circuit entered in the above entitled case on June 19, 1942.

OPINION BELOW.

The findings of fact and opinion of the Board of Tax Appeals (R. 18-34) are reported in 41 B. T. A. 1161. The opinion of the Circuit Court of Appeals (R. 151) is reported in 128 Fed. (2nd) 743.

JURISDICTION.

The judgment of the Circuit Court of Appeals for the Second Circuit was entered on July 6, 1942 (R. 152), and a petition for re-hearing was denied on September 12, 1942 (R. 164). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED.

1. Whether the Circuit Court of Appeals for the Second Circuit departed from the accepted and usual course of judicial proceeding in its decision and opinion concluding that there was substantial evidence to support the determination of the Board of Tax Appeals, that petitioner was availed of during the taxable year for the purpose of preventing the imposition of surtax upon its stockholder.

2. Whether the taxes assessed under Section 104 of the Revenue Act of 1928, in the instant case, are so unreasonable, burdensome and confiscatory as to be in violation of the Fifth Amendment to the Constitution, or amount to a limitation on the powers of the State to control corporations, in violation of the Tenth Amendment to the Constitution.

STATUTES INVOLVED.

The statutes involved are set forth in the Appendix, *infra*, pages 17-18.

STATEMENT.

The petitioner was organized under the laws of Delaware on December 9, 1922 to succeed to and liquidate the partnership of B. H. Howell Sons & Company composed of three partners. This partnership, for a period of about 75 years, had been engaged in the business as commission merchants and fiscal and financial agents for various sugar companies, which began to lose money in 1922 and decided to liquidate and discontinue its business. The partnership

transferred to the corporation many of its assets and liabilities consisting of stocks and securities, bills receivable, cash, claims and certain securities of the individual partners (R. 60-67) for which it issued its capital stock to the former partners in proportion to their partnership interests and the individual assets transferred. The corporation consisted of three stockholders when formed, and in 1925 two of the stockholders withdrew from the corporation taking certain assets and surrendering their stock, which was cancelled, after which James H. Post became the sole stockholder. The corporation continued to hold many of the assets and liabilities it received upon formation and from time to time acquired small amounts of other stock when it had cash to purchase same, and sold some of its assets. Two of its large assets consisting of claims, one against the United States Government in the amount of $1,200,000 and one being the Hoyt claim for $407,500, were finally liquidated in 1932 and 1929, respectively, and the stock of the Dominican Sugar Corporation was not disposed of until 1931 at a loss of over $1,000,000. The petitioner filed the income tax returns for the fiscal years ending November 30, 1923 to November 30, 1931, which income tax returns all showed statutory net losses and no tax due. During these years, eliminating prior year losses as deductions, the statutory net income of the petitioner was as follows:

1923	$192,290.77	(loss)
1924	691,470.67	(loss)
1925	147,832.81	(income)
1926	57,465.45	(income)
1927	58,633.97	(income)
1928	90,657.42	(income)
1929	1,199.51	(loss)
1930	78,109.67	(loss)
1931	1,301,600.94	(loss)

(R. 115.)

The balance sheets and analysis of surplus included in the petitioner's income tax returns showed a deficit for each year, except the year 1930 when it showed a book surplus of $72,947.13, and a deficit for the year 1931 of $1,125,006.16 (R. 114). The assets were carried in the balance sheets at cost. On November 30, 1930 the book value or cost of petitioner's assets was $5,691,223.52. The then market value of the same assets was $4,105,522.78 showing a depreciation in the value of the assets of $1,585,700.74 (R. 82). No dividends were declared or paid by the petitioner from the time of its organization to and including the taxable year ending November 30, 1930. On January 5, 1936 the Commissioner of Internal Revenue determined a deficiency of $56,543.96, which bore interest at 6 per cent from February 1, 1930 under Section 104 of the Revenue Act of 1928 (R. 11-16) on the theory that the petitioner had been formed or availed to prevent imposition of surtaxes on its stockholder. A petition was filed with the Board of Tax Appeals for a re-determination of the deficiency (R. 5-10). On May 15, 1940 a division of the Board of Tax Appeals promulgated findings of fact and opinion affirming the determination by the Commissioner which was not reviewed by the Board (R. 17-34). A motion was filed with the Board of Tax Appeals to have the decision reviewed by the whole Board, which was denied (R. 38). A petition for review was filed with the United States Circuit Court of Appeals for the Second Circuit, which Court, on June 19, 1942, by per curiam opinion, affirmed the decision of the Board (R. 151) and a motion for rehearing was denied on September 12, 1942 (R. 164).*

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* A full statement of the facts is shown by the findings of fact by the Board of Tax Appeals (R. 19-28) and the statement of evidence with exhibits (R. 48-145).

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

1. In finding, concluding and holding that there was substantial evidence to support the findings of the Board of Tax Appeals, that the petitioner had been availed of to prevent the imposition of surtaxes upon its stockholder.

2. In finding, concluding and holding that the questions to be considered by it were questions of fact, and failing to find that the ultimate finding and conclusion of the Board of Tax Appeals was a question of law or mixed law and fact subject to judicial review and the Court's right to substitute its judgment for that of the Board of Tax Appeals.

3. In finding that the evidence, with every reasonable inference to be drawn therefrom, supported the Board's findings of fact, conclusion and opinion.

4. In failing to find that the Board of Tax Appeals' decision resulted in the assessment of taxes contrary to the Fifth and Tenth Amendment of the Constitution.

5. In affirming the Board's order of re-determination of the deficiency in tax of $56,543.96.

REASONS FOR GRANTING THE WRIT.

In its review of the decision of the Board of Tax Appeals, the court below has so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision, specifically in failing to determine the questions of law or mixed law and fact which were raised by the ultimate finding and conclusion of the Board of Tax Appeals.

2. This case presents the question of whether the tax as assessed pursuant to the decision of the Board, as affirmed below, is in violation of the Fifth Amendment to the Constitution.

3. Whether the taxes, as assessed pursuant to the decision of the Board of Tax Appeals as affirmed below, amount to a limitation on the powers of the State to control corporations in violation of the Tenth Amendment to the Constitution.

WHEREFORE, your petitioner respectfully urges that the questions presented are such as should be finally settled and determined by this Court, and that this petition be granted.

David A. Buckley, Jr.

DAVID A. BUCKLEY, JR.,
Attorney for Petitioner.

LORING M. BLACK,
HARVEY L. RABBITT,
Of Counsel.

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SUFFOLK SECURITIES CORPORATION,
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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION.

OPINION BELOW.

The opinion of the Circuit Court of Appeals for the Second Circuit is officially reported at 128 Fed. (2nd) 743 and is printed in the Record (p. 151).

JURISDICTION.

The judgment of the United States Circuit Court of Appeals was entered on July 6, 1942. A petition for rehearing was overruled on September 12, 1942. The jurisdiction of this Court is invoked under Section 240-a of the Judicial Code, as amended by the Act of February 3, 1925.

QUESTIONS PRESENTED.

Questions presented are indicated in the Petition (*ante*, p. 2).

STATUTES INVOLVED.

The statutes are indicated in the Petition (*ante*, p.) and printed in the Appendix (pp. 17-18).

STATEMENT.

A statement of the facts involved is contained in the Petition (*ante*, pp. 2-3).

SPECIFICATION OF ERRORS.

The Specification of Errors to be urged are indicated in the Petition (*ante*, p. 5).

ARGUMENT.

I.

The evidence did not support the ultimate conclusion and decision of the Board of Tax Appeals.

The decision of the Board of Tax Appeals results in the Petitioner paying a 50 per cent tax on $113,087.92, with interest from January 15, 1930, on the theory that it allowed its gains and profits to accumulate for the purpose of preventing the imposition of surtaxes upon its stockholder. Under the decision the Petitioner was obligated to distribute $113,087.92 as a dividend to its stockholder, all of which would not have been subject to surtaxes in the stockholder's personal returns. The uncontradicted evidence in the Record shows that the Petitioner had no accumulated gains and profits or surplus in the taxable year 1930 in the amount of $113,087.92 and had a deficit for each year since its organization except at the end of the year 1930, when it had a book surplus of $72,947.03 and statutory net losses for the years 1929 and 1930 of $1,199.50 and $78,109.87, respectively (Joint Exhibits 9-C and 10-D, R. 114-115).

In order to properly show the gains and profits for the taxable year, the book surplus should have been reduced by the expenses for the year, including the Federal taxes, and interest due, paid or accrued, which in this case would have eliminated the book surplus.

Earnings and profits are computed by deducting from gross receipts the expenses of producing them (*Mobile & Ohio Ry.* v. *Tennessee,* 153 N. S. 486-497). In this classification may be listed such items as extraordinary expenses, charitable contributions, taxes paid the Federal Government, and taxes assessed against local benefits (*R. M. Weyerhaeuser,* 33 B. T. A. 594-597), and cases cited.

The assets of the petition were carried in its book and balance sheets at cost and on November 30, 1930 the then market value was $1,585,700.74 less than cost (R. 82). If the then *market* value had been used in the balance sheets instead of cost, there would have been a deficit of over $1,000,000. Whether a corporation is solvent and has surplus or net profits out of which dividends may be paid must be determined on the basis of the then actual cost or fair market value of its assets.

Mobile & Ohio Ry. Co. v. *Tennessee,* 153 N. S. 86; *Whitaker* v. *Amwell National Bank,* 52 N. J. eq. 400, 29 Atl. 203; *American Steel & Wire Co.* v. *Eddy,* 138 Mich. 403, 101 N. W. 578; *Siegman* v. *Electric Vehicle Co.,* 140 Fed. 117; *Cannon* v. *Wiscassett Mills Co.,* 195 N. C. 119, 141 S. E. 344.

In the case of *W. S. Farish & Co.* v. *Commissioner,* 38 B. T. A. 150 Aff'd 104 Fed. (2nd) 833, the Board said:

> "Application of the statute obviously depends upon the existence of 'gains and profits' which have been accumulated (instead of being divided or distributed) for the purpose of preventing the imposition of tax upon the shareholders. If petitioner corporation had no accumulated gains or profits to be divided or distributed in the taxable year, it could not have been availed of for the proscribed purpose."

Therefore, under no theory could the Petitioner have distributed to its stockholder as dividends any amount in excess of $72,947.03, nor did the stockholder have to report any larger amount in its personal returns under Section 104(d) to be relieved of the 50 per cent tax (Appendix, pp. 17-18). Any amount distributed in excess of the surplus would have been a distribution from capital and would not be taxable income to the stockholder. It is well settled that a distribution by a corporation to its stockholders out of its capital and not out of gains and profits accumulated since February 28, 1913 are not taxable income to the recipients (*Foley Securities Corporation* v. *Commissioner,* 106 F. (2d) 731; *Helvering* v. *Jarvis,* 123 F. (2d) 742; *Reinstrom* v. *Commissioner,* 125 F. (2d) 790; *Patty* v. *Helvering,* 98 F. (2d) 717). Therefore, the Petitioner could not have been availed of to prevent the imposition of surtaxes on any amount in excess of its earnings or profits.

The Commissioner determined that the Petitioner had no net income for the year 1930 but a net loss of $47,674.60 and no tax due under Section 13 (Deficiency Letter, R. 16).

Section 104(a) provides for a tax of 50 per cent of the *net income,* which shall be in addition to the tax imposed by Section 13. In Section 104(c) the term "net income" is defined as the net income as defined by Section 21 increased by the amount of dividends allowed under Section 23 (p) (Appendix, pp. 17-18). Section 21 defines "net income" as the gross income computed under Section 22 less the deductions allowed by Section 23.

There is a distinct difference between net income and gains and profits. Taxable net income is purely a statutory concept and bears no necessary relation to gains and profits subject to distribution as dividends (*W. S. Farish & Co.,* 38 B. T. A. 150; *Ida C. McKinney,* 32 B. T. A. 450).

Gains and profits mean the stockholder's share of the corporation's gains and profits for the year, i.e., that portion which a corporation might properly distribute to its stockholders as dividends. The Revenue Acts impose taxes

on statutory net income. It is contended that a corporation which had no statutory net income under Section 21 in a taxable year would not be subject to taxes under Section 104. Even though Section 104(c) provides that the net income shall be increased by the amount of dividends, there would have to be a net income before it could be increased by the dividends. This question has not been passed on by the Board or any of the courts and it is doubtful that it was ever raised, as in most of the cases heretofore decided where Section 104 was attempted to be applied, the corporation had statutory net income in the taxable year and paid taxes under Section 13 or similar Sections of the Revenue Acts.

In *A. D. Sanger, Inc.* v. *Commissioner* (84 F. (2d) 23-24), the Court said:

> "Of course, if the corporation fails to have gains and profits to the extent that there is no net income, the tax fails."

The Board held that the Petitioner was a mere holding or investment company which raised the presumption that it was availed of to prevent the imposition of surtax on its stockholder, which presumption was not disproved by petitioner evidence (R. 29). The Board did not find as a fact that the corporation had allowed its gains and profits to accumulate beyond its reasonable needs.

Therefore, there would be no presumption under that part of the Section that the Petitioner was availed of for the prohibited purpose. Whether the Petitioner was a *mere* holding or investment company is a question of law or a question of mixed law and fact. Petitioner has heretofore contended that it was not a mere holding or investment company but was formed and operated for the purpose of the liquidation of the partnership and it was unable to liquidate before the taxable year because of its inability to dispose of its assets to pay its creditors in full and the return of its capital to its stockholder.

One of its large assets, the United States Government claim, was not finally liquidated until 1932. (R. 90) Another of its large assets, the Dominican Sugar Company, was not disposed of until 1931 at a loss of over a million dollars (R. 104), and some of its largest notes and debts payable were secured by its assets, to liquidate which would have imperiled the security of the loan to its creditors. It is contended that the Petitioner was not a *mere* holding or investment company and there was no presumption that it was availed of for the proscribed purpose (*Flint* v. *Tracy Co.*, 220 U. S. 107-171; *Chicago Stockyards Company* v. *Commissioner*, reversing B. T. A., 129 Fed. (2d) 937. Certiorari granted Dec. 7, 1942; *United States Industrial Bankers Securities Corporation* v. *Higgins*, 104 F. (2d) 177; *Chevrolet Motor Company* v. *United States*, 64 Ct. Cl. 211, Certiorari Denied, 277 U. S. 585).

Even if there was a presumption to rebut, it is submitted that a consideration of all the evidence in the case with the proper inferences to be drawn therefrom, would show the lack of intent or purpose to evade surtaxes.

The ultimate finding by the Board of Tax Appeals that the Petitioner was availed of for the purpose of preventing the imposition of surtaxes on its stockholder is a question of law or a determination of mixed law and fact, based on the Board's findings of primary, evidentiary or circumstantial facts, is subject to judicial review and on such review the Court may substitute its judgment for that of the Board (*Helvering* v. *Tex-Penn Company*, 300 U. S. 481; *Farmer* v. *Commissioner*, 126 F. (2d) 542; *United States* v. *State Street Trust Company*, 124 F. (2d) 948; *Chicago Stockyards, supra*).

In the case of *Helvering* v. *Tex-Penn Company*, the Court said:

> "The ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary or circumstantial facts. It is sub-

ject to judicial review and, on such review, the court may substitute its judgment for that of the Board. Helvering v. Rankin, 295 U. S. 123."

If the Board's findings of primary, evidentiary or circumstantial facts is erroneous, then the findings would not support the ultimate finding. In the Board's Opinion (R. 30), it indicates that because the Petitioner's assets exceeded its liabilities and it was not insolvent, that it was obligated to declare dividends or make distribution to its stockholder, on which finding, no doubt, the Board based its ultimate finding. This assumption is clearly erroneous, as it is well established that in considering whether a corporation has accumulated gains and profits out of which to declare dividends, the capital stock should be taken into consideration (*Willcutts* v. *Milton Dairy Company,* 275 U. S. 215; *Helvering* v. *Canfield,* 281 U. S. 163; *Mobile & Ohio Ry. Co.* v. *Tennessee,* 153 U. S. 486). It is difficult to determine upon which primary or evidentiary facts the Board based its ultimate finding. The evidence shows that the book surplus was not large in comparison with a corporation with assets of a book value of over $5,000,000 and capital stock outstanding of over $4,000,000 and which had net losses for the year. The additional tax that the sole stockholder of Petitioner would have been liable for had the book surplus of $72,947.03 been distributed to him, would have amounted to less than $15,000, or the stockholder could have reported the amount of the book surplus without it being distributed to him, in his personal return, and it would have only increased his personal taxes by less than $15,000. The petition reported $817,055.85 as dividends received from domestic corporations from 1923 to 1930. James H. Post, petitioner's stockholder, reported in his personal returns dividends of $1,008,952.39 for the years 1926 to 1930 (R. 22). Those facts, when balanced against the fact that at the time the Commissioner made his determination of a deficiency on January 15, 1936 of $56,543.96 plus interest at 6 per cent for six years and two months, which would mean a deficiency

of 88 per cent on the constructed net income of $113,087.92, are repugnant to the existence of a purpose or intent to evade surtaxes (*U. S.* v. *T'way Coal Sales Co.*, 75 F. (2d) 336-337; *Chicago Stockyards Co.* v. *Commissioner, supra*).

In the case of *Estate of James H. Post, deceased, et al.*, v. *Commissioner*, Docket No. 83921, Memorandum Opinion decided April 26, 1939, involving the year 1932, the Board had under consideration the question of the method of accounting employed by Mr. Post in filing his individual returns and the amount of deductions allowable for contributions. In considering this case, the Board went thoroughly into Mr. Post's transactions, including his transactions with the Suffolk Securities Corporation, B. H. Howell Son & Co., Inc., for the years 1922 to 1933, and his income and deductions for the year 1932. The Board held that his accounts had been kept on the accrual basis and that he was limited in the deduction of his contributions to charity. On page 16 of the Board's opinion, it stated:

> "The record shows that James H. Post was a very wealthy man and a philanthropist, very generous in his contributions to public charities. There is nothing in the record indicating that his business transactions involved in this proceeding *were otherwise than bona fide or that the methods of keeping his books and making his income tax returns ever were for the purpose or with a view to evading payment of income tax.* His bookkeeper and confidential secretary, Frank W. Valentine, who was also secretary of B. H. Howell Son & Co., Inc., and Suffolk Securities Corporation, was familiar with the business and accounting methods and transactions of both corporations and had charge of their offices and the preparation of their income tax returns. He also prepared the income tax returns of James H. Post and wife, Louisa Wells Post, for 1932 and prior years. The bookkeeping method or system which he used in 1932 was the same he had used for many years and was used by him in keeping the books and preparing the returns of both aforesaid corporations and of James H. Post and wife." (Italics supplied).

II.

The taxes as assessed are violative of the Fifth and Tenth Amendments to the Constitution.

The taxes imposed in this case are in fact a penalty and are more than those imposed for fraud under the 1928 Act. The penalty for fraud is 50 per cent of the tax, whereas the penalty under Section 104 is 50 per cent of the net income, including dividends, plus interest, a much more severe penalty than for a fraud (*Child Labor Tax Case*, 259 U. S. 34; *Hill* v. *Wallace*, 259 U. S. 44; *Carter* v. *Carter Coal Co.*, 298 U. S. 238; *Lipke* v. *Lederer*, 259 U. S. 557).

The taxes assessed in the instant case are so unreasonable, burdensome, and confiscatory that they are in violation of the Fifth Amendment to the Constitution (*Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1; *Barclay & Co.* v. *Edwards*, 267 U. S. 442; *Nichols* v. *Coolidge*, 275 U. S. 531).

Sections 34 and 35 of the General Corporation Laws of Delaware prohibited the Petitioner from declaring a dividend to its stockholder on the condition of its assets, liabilities and surplus at the end of the year 1930 (Appendix, Page 17) (*Vogtman* v. *Michaels Mortgage and Credit Company*, Delaware Chancery Reports, Vol. 20, Page 364; *Randall as Trustee of Bush Terminal Company* v. *Bailey, et al.*, 23 N. Y. S. (2d) 173).

The power to regulate corporations as to their creation, operation and relations with their directors and stockholders is strictly reserved to the States by the Tenth Amendment and the Federal Government cannot interfere with that power. It may be true that Section 104 ordinarily does not limit the powers of the corporation or the State to control it, as was held in *Helvering* v. *National Grocery Company*, 304 U. S. 282-286. However, the assessment of the penalty tax in this case certainly penalizes the corporation for not doing that which it was prohibited from doing by the State, especially as to any distribution in excess of its earnings and profits, and would conflict with or amount

to a limitation on the power of the State (*Child Labor Tax Case, supra; United States* v. *Jin Fuey Moy,* 241 U. S. 394).

Chief Justice Taft said in the *Child Labor Tax Case:*

> "There comes a time in the extension of the penalizing feature of the so-called tax when it loses its character as such and becomes a mere penalty, with the characteristics of regulation and punishment."

CONCLUSION.

For the foregoing reasons it is respectfully urged that this petition for a writ of certiorari should be granted.

Respectfully submitted,

David A. Buckley

DAVID A. BUCKLEY, JR.,
Attorney for Petitioner.

LORING M. BLACK,
HARVEY L. RABBITT,
Of Counsel.

APPENDIX.

Laws of Delaware 1929

Chapter 135—Domestic Corporations

1948 Section 34 Dividends; Reserves

The Directors of a Corporation shall have power to declare and pay dividends upon the shares of its capital stock either (a) out of its net assets in excess of its capital as computed in accordance with the provisions of Sections 14-26-27-28 of this chapter, or (b) in case there shall be no such excess out of its net profits for the fiscal year, then current and/or preceding fiscal years, and provided, however, that if the capital of the corporation computed as aforesaid shall have been diminished by depreciation in the value of its property or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired.

STATUTES INVOLVED.

Revenue Act of 1928; 45 Stat. ch. 852, page 791:

"Sec. 104. Accumulation of Surplus to Evade Surtaxes.

"(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for

each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

"(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

"(c) As used in this section the term 'net income' means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

"(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included."

"SEC. 115, DISTRIBUTIONS BY CORPORATIONS

"(a) Definition of dividend.—The term 'dividend' when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913."

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute involved	2
Statement	2
Argument	6
Conclusion	11
Appendix	12

CITATIONS

Cases:

Almours Securities v. *Commissioner*, 91 F. 2d 427, certiorari denied, 302 U. S. 765, rehearing denied, 303 U. S. 666 — 6, 7, 9, 10

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Helvering v. *Northwest Steel Mills*, 311 U. S. 46 — 10

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Wilmington Trust Co. v. *Commissioner*, 316 U. S. 164 — 6

Statute:

Revenue Act of 1928, c. 852, 45 Stat. 791:

Sec. 21 — 9

Sec. 23 — 12

Sec. 104 — 9, 12

Sec. 118 — 14

504293—43

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 583

SUFFOLK SECURITIES CORPORATION, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 18–34) is reported in 41 B. T. A. 1161. The opinion of the United States Circuit Court of Appeals for the Second Circuit (R. 151) is reported in 128 F. 2d 743.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 6, 1942 (R. 153). A petition for rehearing was denied September 12, 1942 (R. 165). The petition for a writ of certiorari was

filed December 12, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the Circuit Court of Appeals correctly sustained the findings of the Board of Tax Appeals that the taxpayer was a mere holding or investment company and that it was availed of for the purpose of preventing the imposition of the surtax upon its sole stockholder through the medium of permitting its gains and profits to accumulate instead of being divided or distributed within the meaning of Section 104 of the Revenue Act of 1928.

2. Whether the 50 percent tax assessed against the taxpayer pursuant to said section violates the Fifth and Tenth Amendments to the Constitution.

STATUTE INVOLVED

The statute involved is set forth in the Appendix, *infra.*

STATEMENT

The evidence before the Board of Tax Appeals consisted of a stipulation of facts and the testimony of one Valentine, the secretary of the taxpayer corporation. The material findings made by the Board upon this evidence may be summarized as follows (R. 19–34):

For many years prior to 1922, B. H. Howell Son & Company, a partnership composed of James H.

Post, Frederick H. Howell and Thomas A. Howell, had engaged in business as commission merchants making distribution of sugar and as fiscal and financial agents for various sugar companies. Early in 1922 the partners determined to discontinue the partnership business and to form a corporation to take over certain of the partnership assets and liabilities. Accordingly the taxpayer, Suffolk Securities Corporation, was formed on December 9, 1922, with Post and the two Howells as its stockholders. (R. 19, 20.) The partnership then transferred to taxpayer certain of its assets, chiefly securities and accounts receivable, but continued in business to perform its remaining contracts, later becoming incorporated. Post and the two Howells also transferred to taxpayer property owned by them individually. Post transferred stocks and bonds having a value of $2,110,412 and the others lesser amounts. The agreed net value of all the assets received by taxpayer was $7,373,129.56. (R. 20–21.)

Post became the sole stockholder of taxpayer on February 5, 1925. Prior to that date Post and Frederick H. Howell had transferred other securities belonging to them individually to a corporation, wholly owned by Thomas A. Howell, in exchange for the latter's shares of taxpayer's stock. (R. 21.) On that date Frederick H. Howell surrendered his stock in taxpayer and in consideration thereof taxpayer transferred certain of its

assets to a corporation of which Frederick H. Howell was the sole stockholder (R. 21). Post continued to be the sole stockholder in taxpayer until his death in 1938 (R. 21).

From time to time Post borrowed money from taxpayer. Between September 20 and November 30, 1926, he borrowed $42,066.33, which he repaid with interest on February 15, 1927. Between January 30 and March 27, 1928, he borrowed $27,000, which he repaid with interest on April 24, 1928. Between September 4, 1928, and November 30, 1930, he borrowed $662,019.63 of which he repaid $25,000 on August 25, 1930. (R. 22.)

Taxpayer, from the date of its organization to and including 1930, the taxable year in question, kept its books and filed its income tax returns on the accrual basis, and such returns reported no income or taxes due. Taxpayer carried its assets on its books and on the balance sheets in its income tax returns at cost. The balance sheets showed a deficit at the beginning and end of each year except at the end of the taxable year. On the last day of that year, November 30, 1930, the balance sheet showed a surplus of $72,947.03.[1] (R. 21–22.)

---

[1] If market value were placed on the assets, the taxpayer would show a capital deficit rather than a surplus (R. 30).

The Board also found that at November 30, 1930, the taxpayer had liabilities of $1,695,441.94 and held assets having a total book value or cost of $3,534,079.81 and a total market value of $2,625,810.03 (R. 23). Thus, the Board stated in its opinion (R. 29–30) the book value or cost of the assets

During the years 1923–1930, taxpayer received dividends from domestic corporations amounting to $817,055.85—it received $160,762.52 during the taxable year—but at no time did it declare or pay dividends. Post himself received dividends from other corporations for he reported in his returns for each of the years 1926–1929 dividends of about $100,000 and, for 1930, dividends of $270,128.37 in his individual return and of $338,694.14 in a joint return with his wife. (R. 22.)

The Board's ultimate finding was that (R. 27-28)—

> During the taxable year, petitioner was a mere holding or investment company, and it was availed of for the purpose of preventing the imposition of the surtax upon its sole stockholder through the medium of permitting it gains and profits, to accumulate instead of being divided or distributed.

The court below affirmed the decision of the Board *per curiam* on the ground that the chief question "turns on Post's purpose in allowing the money to accumulate in the taxpayer's treasury; that was a question of fact as to which there was

---

exceeded the liabilities by $1,838,637.87, and that their market value exceeded the obligations by $930,368.09. It should be observed, however, that Exhibit O of the stipulation of facts (R. 82–83) shows a book value for the taxpayer's assets of $5,691,223.52 and a market value of $4,105,522.78. These figures, which the taxpayer uses in computing the difference between book value and market value (Br. 9), show an excess over liabilities of $3,995,781.58 on the basis of book values, and $2,410,080.84 on the basis of market values.

substantial evidence to support the finding of the Board" (R. 151).

ARGUMENT

1. The decision below was based on correct principles. The question whether the taxpayer was availed of for the purpose interdicted by Section 104 of the Revenue Act of 1928 is one of fact on which the finding of the Board is conclusive if supported by substantial evidence. *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, 294; *cf. Wilmington Trust Co.* v. *Commissioner*, 316 U. S. 164. The same is true of the Board's finding that the taxpayer was a mere holding or investment company. *Cf. R. L. Blaffer & Co.* v. *Commissioner*, 103 F. 2d 487 (C. C. A. 5th), certiorari denied, 308 U. S. 576, rehearing denied, 308 U. S. 635; *Almours Securities* v. *Commissioner*, 91 F. 2d 427 (C. C. A. 5th), certiorari denied, 302 U. S. 765, rehearing denied, 303 U. S. 666.

The subsidiary findings, which we have summarized in the statement, are not in dispute. We believe it evident, without the necessity of detailed discussion, that they are sufficient to support the ultimate determination.

2. The taxpayer contends that it was not a mere holding or investment company, because it was formed and operated to liquidate the partnership, and it had been unable to complete liquidation prior to the taxable year (Br. 11–12). Even if this argument had not been foreclosed by the

Board's findings and was properly available on review, it plainly would not merit a reversal. Since 1925 Post had been sole stockholder of the taxpayer, its function, as a device for liquidating the interests of the various members of the partnership, necessarily terminated at that time. As the Board stated, the taxpayer did not contend that in the taxable year it was a business corporation; "that is, one engaged in carrying on a business enterprise." Rather, it was "merely holding a limited amount of securities transferred to it by Post, and in that connection buying and selling securities, and investing and reinvesting its funds." (R. 29.) These activities characterize it as a mere holding or investment company. See *Almours Securities* v. *Commissioner, supra,* and *R. L. Blaffer & Co.* v. *Commissioner, supra.* The fact that the corporation may have held claims in its portfolio which had not yet been liquidated, and that it owed various obligations, which, it is alleged, prevented its own liquidation (Br. 12), is by no means inconsistent with this conclusion.

3. The taxpayer also contends that the facts (1) that distribution of the taxpayer's book surplus of $72,947.03 to Post in 1930 would only have increased his personal taxes by $15,000 and (2) that he had reported dividends in his personal returns of $1,008,952.39 for 1926 to 1930 in contrast with the dividends received by the taxpayer of only $817,055.85, negative any intent to avoid surtaxes

(Br. 13–14). But again it is obvious that the argument is without merit, even if it had not been foreclosed by the Board's finding. The statute does not require a showing that the corporation has been availed of to avoid *all* surtaxes; nor does it contemplate that the tax assessed merely compensate for the surtax avoided. *Cf. A. D. Saenger, Inc.* v. *Commissioner,* 84 F. 2d 23, 24 (C. C. A. 5th).

Similarly, there is no merit to the contention that there could have been no intention to avoid surtaxes because the taxpayer, although it had a book surplus, had an actual capital deficit, due to the depreciation in market value of its securities, and could not distribute dividends (Br. 10). The circumstance would at most be evidentiary. *Cf. A. D. Saenger, Inc.* v. *Commissioner, supra.* The compelling facts are (1) that the taxpayer received dividends between 1923 and 1930 in the sum of $817,055.85 and during the taxable year in excess of $160,000, which were not distributed; and (2) that from September 4, 1928, to November 30, 1930, Post borrowed from the taxpayer sums in excess of $650,000, thus taking dividends in another guise. Whether or not the corporation was *legally* able to make a distribution, it was equally useful as a medium for avoiding surtax.

Moreover, allegations that insolvency resulted from an unrealized depreciation in the market value of securities have been uniformly held not to remove the corporation from the reach of the

statute. *A. D. Saenger, Inc.* v. *Commissioner, supra; Almours Securities* v. *Commissioner, supra; R. L. Blaffer & Co.* v. *Commissioner, supra.* In *Helvering* v. *Nat. Grocery Co., supra,* this Court held that the fact an unrealized depreciation in the market value of securities exceeded the current profits would not prevent application of Section 104.[2] The question here is essentially the same.

4. The taxpayer urges that the Court review the question whether the tax imposed by Section 104 can be applied to a corporation which has no net income for normal tax purposes (Br. 10–11). Section 104 (c) provides that the term "net income" as used in that section shall mean "the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner." Section 21 defines net income as "the gross income computed under section 22, less the deductions allowed by section 23." The taxpayer's gross income less the deductions provided in Section 23 showed a net loss; however, inclusion in the computation of the amount of the dividends

[2] *W. S. Farish & Co.* v. *Commissioner*, 38 B. T. A. 150, affirmed, 104 F. 2d 833 (C. C. A. 5th), cited on p. 9 of the taxpayer's brief, involved an operating deficit and therefore is not in point, even if we assume, *arguendo*, that it was correctly decided.

for which the taxpayer had received a deduction for dividends received under Section 23 (p) showed the net income upon which the tax in issue was computed (R. 16).

The purpose of Section 104 (c), of course, is to include in the Section 104 net income, income which would be taxable in the hands of the stockholders even though deductible in the hands of the corporation. Construction of the statute in accordance with the suggestion of the taxpayer would patently distort this purpose. There is no call for consideration of the point by this Court.

5. The questions raised by the taxpayer as to the constitutionality of Section 104 were resolved by this Court's decision in *Helvering* v. *Nat. Grocery Co., supra.* Constitutional issues were also raised in the petitions for certiorari in the *Almours Securities* and *R. L. Blaffer & Co.* cases, *supra,* but the writs were denied. And the Court has recently held that a tax upon undistributed corporate profits is valid even where an applicable state statute prohibits distribution, *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46, 52–53.

CONCLUSION

There is no conflict. The case was correctly decided, and it involves no questions calling for review. Accordingly, the petition for certiorari should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
SAMUEL H. LEVY,
CARLTON FOX,
Special Assistants to the Attorney General.

JANUARY 1943.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(f) *Losses by corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(h) *Loss on sale of stock or securities.*—For disallowance of loss deduction in the case of sales of stock or securities where within thirty days before or after the date of the sale the taxpayer has acquired substantially identical property, see section 118.

* * * * *

(j) *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part.

* * * * *

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the

medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt

from tax in the amount of the share so included.

* * * * *

SEC. 118. LOSS ON SALE OF STOCK OR SECURITIES.

In the case of any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) or has entered into a contract or option to acquire substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, no deduction for the loss shall be allowed under section 23 (e) (2) of this title; nor shall such deduction be allowed under section 23 (f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business. If such acquisition or the contract or option to acquire is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed.

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SUFFOLK SECURITIES CORPORATION,
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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

REPLY BRIEF OF PETITIONER.

DAVID A. BUCKLEY, JR.,
Attorney for Petitioner.

LORING M. BLACK,
HARVEY L. RABBITT,
Of Counsel.

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INDEX

Page

Reply Brief 1

CITATIONS

CASES:

Chicago Stockyards Co. v. Commissioner, 91 Fed. (2nd) 937 2
Helvering v. National Grocery Co., 304 U. S. 282... 3
Helvering v. Northwest Steel Mills, 311 U. S. 46.... 3

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REPLY BRIEF OF PETITIONER.

1. There is no question and it is freely conceded that the Suffolk Securities Co. was not formed for any purpose concerning surtaxes or the nonpayment of surtaxes. The great old sugar mercantile house of B. H. Howell & Co. was financially embarrassed in 1922 and with the consent of the bank its operation and assets were set aside in various forms (R. 18, 86). One of the means used was the Suffolk Securities Co. This company assumed large liabilities to the banks and took over the liquidation of the Argentine contracts (R. 21). This latter operation, for

example, was not concluded until 1932 (R. 90). From time to time as some of the Howells were released they, in turn, took down their share of the Suffolk Security Co. and gradually the late Mr. James H. Post was left as the sole shareholder (R. 21).

In the case at bar the year 1930 is in question. No other year in the history of the corporation is or has been in dispute since its organization in 1922.

The above facts are stated in response to the reply brief as they are apparently overlooked in the consideration in that brief.

2. This Court has accepted for review the case of *Commissioner* v. *Chicago Stockyards Co.*, 129 Fed. (2nd) 937, which involves the assessment of taxes under Section 104 of the Revenue Act of 1928 and 1932. The present case involves many of the same legal points and merits the consideration of this Court at the same time.

3. There was no motive in this case for the evasion of surtaxes. Mr. Post was a great benefactor of charity and for at least nine years had given away practically all his income (R. 120-124). Any finding which picks out one year under Sec. 104 presents an isolated and purely arbitrary presumption contrary to the facts and the law. Mr. Post's motives are attacked because the respondent's brief says he borrowed money from the company, but the record shows that a large part of this was to pay off B. H. Howell & Co., loans—in other words it was all part of the liquidating of the old firm. Another part of the borrowings was offset completely by loans to the company and this money came from another liquidating source (R. 92).

4. The words in the statute "availed of * * *" have never been fully interpreted by this Court. Certainly one year in the life of a corporation devoted to its original objects cannot be isolated and made the subject of a penalty. The infliction of a penalty tax is not in accord with a reasonable interpretation of law nor application.

5. The respondent on page 10, paragraph 5 of its brief, cites the case of *Helvering* v. *National Grocery Co.*, 304 U. S. 282-294, and *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 52-53, in support of the constitutionality of Section 105, as applied in the case.

The National Grocery Co. case did not involve the question of the right under the Delaware Statute to declare a dividend when there was a deficit because of a depreciation in the value of its assets or the distribution of more than a book surplus. In that case the company had a large accumulated surplus even after allowance for the depreciation of its assets and the Delaware Statute did not prohibit it from declaring dividends (Petitioner's Brief, page 17). In the instant case there was a deficit after depreciation of its capital and its book surplus for the year was less than the amount upon which the 50% tax was imposed.

The *Northwest Steel Mills* case involved a different section of the law, which imposed taxes on undistributed profits for the year, and did not involve the question of distribution from accumulated surplus or deficit.

6. We believe the questions in this case need a healthy and complete review and the *Chicago Stockyards* case presents this opportunity. This case likewise presents certain novel points of law. It will be helpful to have these questions decided by this Court.

Respectfully submitted,

DAVID A. BUCKLEY, JR.,
Attorney for Petitioner.

LORING M. BLACK,
HARVEY L. RABBITT,
Of Counsel.